Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Lieber
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Bill Number: AB 2982

Related Bills: See Prior Analysis
Telephone: 845-4335
Amended Date: May 17, 2006

Attorney: Patrick Kusiak
Sponsor:

SUBJECT: S Corporations/Carryforward of Net Operating Loss (NOL) and Tax Credits

X DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced February 24, 2006.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended ____________________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________________.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 24, 2006, STILL APPLIES.

X OTHER – See comments below.

SUMMARY

This bill would retroactively allow certain S corporations to use suspended credits and net operating losses (NOLs) created prior to 2002.

SUMMARY OF AMENDMENTS

The May 17, 2006, amendments would deny use of C corporation NOLs by shareholders and additionally provide rules to prevent those NOLs from being used more than once.

The May 17, 2006, amendments impact revenue and a new revenue estimate is provided. The May 17, 2006, amendments resolved the IMPLEMENTATION CONSIDERATIONS and one of the POLICY CONCERNS. The remaining POLICY CONCERN has not changed and is restated for convenience. In addition, a revised discussion under THIS BILL is provided. Except for these changes, the remainder of the previous analysis of the bill as introduced February 22, 2006, still applies.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	5/22/06
____ N	____ OUA	X PENDING		

POSITION

Pending.

ANALYSIS

THIS BILL

For a C corporation required to be an S corporation for California purposes under the provisions of AB 1122 (Corbett, Stats. 2002, Ch. 35), this bill would make the following changes:

- Allow NOLs generated in a C corporation taxable year to be carried forward to an S corporation taxable year under the NOL provisions in effect for the year the NOL was generated. For example, 55% of an NOL generated in 2001 would be allowed to be taken in 2004.[1] The provision permits the NOL to reduce taxable income for purposes of the 1.5% corporate level tax imposed on an S corporation and provides rules for the reduction of the C corporation NOLs that were used to reduce the built in gain (BIG) tax in years prior to the enactment of this bill. Once this bill is enacted, the C corporation NOLs would only be permitted to reduce taxable income for purposes of the 1.5% corporate level tax imposed on an S corporation and not the BIG tax.
- Allow 100% (versus one-third) of credits generated in a C corporation tax year to be applied against the 1.5% corporate level tax imposed on an S corporation. The amount of the credit available for taxable years beginning on or after January 1, 2003, would be the credit carryforward amount as of the last day the corporation was a C corporation, reduced by the amount of the credit used in the S corporation's 2002 tax year and increased by the portion of the credit (two-thirds) not available to be utilized under the 2002 tax law. The individual credit's rules in effect in the year the credit was generated would apply.

Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact of AB 2982 As Amended May 17, 2006 Effective for Tax Years BOA 1/1/2003 Assumed Enactment Date After 6/30/06 ($ in Millions)		
2005/06	2006/07	2007/08
-$1.5	-$1.5	-$1.5

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

[1] California suspended NOLS for tax years 2002 and 2003.

Revenue Discussion

The revenue loss for this proposal has been reduced from the original estimate because the bill as amended May 17, 2006, would deny use of NOLs generated in C corporation years by S corporation shareholders.

The revenue impact of this proposal is dependent on the number of corporations that converted to S-corporation status for taxable year 2002 and the NOLs and credits available for use.

According to the department's micro-simulation NOL model, the stock of NOLs for converted S-corporations at the end of taxable year 2001 totaled $863 million. Applying an average marginal tax rate of 1.0% for S corporations and assuming NOLs would be used over a seven-year period, would result in annual losses of $1 million ($863 million X .01 / 7).

The two most frequently reported credits are the Manufacturers' Investment Credit and the Research & Development credit. The credits available to a C corporation required to be an S corporation for California purposes under the provisions of AB 1122 (Corbett, Stats. 2002, Ch. 35) for carryover from previous years for both credits is approximate $60 million. It is estimated that converted S-corporations' average usage rate would approximate $500,000 annually.

ARGUMENTS/POLICY CONCERNS

AB 1122 (Corbett, Stats. 2002, Ch. 35) provided that federal S corporations will always be treated as S corporations for California purposes. The April 27, 2005, Senate Revenue and Taxation Committee analysis of SB 259 (Campbell, 2005/2006), which was substantially the same as this bill, states that:

> "The thought behind this reform was that corporations electing to be C corporations for state purposes but S corporations for federal purposes were taking advantage of federal-state differences to reduce their tax liability, and that this change would generate some $20 million of additional revenue for 'budget-balancing' purposes for the 2002 budget. This bill would back away from this reform, and allow those who chose to retain California C corporation status while continuing as federal S corporations to retain the tax advantages of the federal / state differences in elective S corporation status."

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